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Cash Flow Trends and Their Fundamental Drivers: Comprehensive Review (Quarter 2, 2011)

Free Cash Margin Index:

2.43%, 3.96%	4.63%	7.18%
Recession Lows	**Current**	**Recent High**
(Mar. 2001, Dec. 2008)	**(June 2011)**	**(March 2010)**

Median free cash margin declined for the fifth straight twelve-month reporting period off of its March 2010 high of 7.18%. The metric now stands at 4.63% for the twelve months ended June 2011, down from 5.20% in the March 2011 period. Continuing recent trends, companies are increasing investments in inventory and fixed assets, the net effect of which is reduce free cash margin. Inventory days increased to 24.00 days in the June 2011 reporting period from 23.14 days in March 2011. Capital expenditures as a percent of revenue also increased, to 3.16% in the June period from 3.01% in March.

While free cash margin continued it decline, some bright spots began to appear during the June 2011 reporting period. Both median revenues and free cash flow increased. Median revenues increased 14.9% in the twelve months ending June 2011 to $633.57 million from $551.41 million in the twelve months ending March 2011. Median free cash flow grew 4.25% to $21.72 million in June from $20.71 million in March.

During the June 2011 reporting period only 3 of the 44 industries in the sample, Shipbuilding and Railroad Equipment, Defense, and Precious Metals, reported increasing free cash margin. There were 19 industries with declines in free cash margin and 22 industries with a stable free cash margin. The individual companies examined in this report are: Marine Products Corp (MPX), Coeur D Alene Mines Corp. (CDE), Deckers Outdoor Corp. (DECK), Under Armour Inc (UA) and Chesapeake Energy Corp. (CHK).

Data for this research were provided by Cash Flow Analytics, LLC., www.cashflowanalytics.com. Charles Mulford is a principal in Cash Flow Analytics, LLC. **October, 2011**

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Georgia Tech Financial Analysis Lab

The Georgia Tech Financial Analysis Lab conducts research on issues of financial reporting and analysis. Unbiased information is vital to effective investment decision-making. Accordingly, the Lab thinks that independent research organizations, such as this Lab, have an important role to play in providing information to market participants.

Because the Lab is housed within a university, all of its research reports have an educational quality, as they are designed to impart knowledge and understanding to those who read them. Its focus is on issues that it believes will be of interest to a large segment of stock market participants. Depending on the issue, it may focus its attention on individual companies, groups of companies, or on large segments of the market at large.

A recurring theme in the work is the identification of reporting practices that give investors a misleading signal, whether positive or negative, of corporate earning power. The Labs defines earning power as the ability to generate a sustainable stream of earnings that is backed by cash flow. Accordingly, its research may look into reporting practices that affect either earnings or cash flow, or both. At times, its research may look at stock prices generally, though from a fundamental and not technical point of view.

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Free Cash Margin Index*:

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The ***Free Cash Margin Index** is free cash flow measured as a percentage of revenue for the trailing twelve month period.

Introduction

This research report is part of a continuing series that examines cash flow trends and the underlying drivers that are causing changes in those trends. The current study contains a review of the cash flow performance of all non-financial companies for a series of rolling twelve-month periods from the first quarter of 2000 through the second quarter of 2011. Additionally, it looks at individual industry results and focuses its attention on the cash flow performance of several companies in those industries that stood out with improving free cash margin and in those that suffered from significant declines in free cash margin. All companies with a current market capitalization of $50 million or more are included, resulting in a total sample of 3,017 companies. Please see page 7 for a list of industries included. That list is followed by a summary of the findings.

Measured as free cash flow divided by revenue, free cash margin is a cash flow profit margin. It indicates what percent of revenue is left for shareholders in the form of free and discretionary cash flow. If the company sells its products or services for a dollar, free cash margin tells how many cents the shareholders can take home without reducing the company's ability to generate more. Thus, as the report looks at cash flow trends and their underlying drivers, its particular interest is on how those factors impact free cash margin.

For more detail, the industry spreadsheets that identify trends in free cash margin and its underlying drivers for 44 separate industries for all available reporting periods through the second quarter of 2011 have been posted on the Lab's website at www.mgt.gatech.edu/finlab.

Continuous Focus on Cash Flow

Corporate financial success is dependent not only on a company's ability to generate revenues and earnings, but also cash flow, especially free cash flow. It is free cash flow and growth in free cash flow, that discretionary stream of cash that a company can put to use for acquisitions, debt retirement, dividends and stock buybacks that works with growing earnings to drive firm value higher. Because it is "free," free cash flow comes with no strings attached. It is truly discretionary. Spending it does not impact the company's ability to generate more. A company with revenue growth will eventually lose the favor of investors if it never finds a way to generate earnings. In a similar way, a company with profits that is unable to generate cash will also experience waning investor enthusiasm. It may take a while. Investors are patient with profitable, growing companies. Ultimately, however, a company must show an ability to generate free cash flow.

Companies that consume cash must continually seek new sources of capital – whether debt or equity. At some point, those sources of capital will dry up or become prohibitively expensive if the firm does not show at least some progress toward getting closer to positive cash generation. Worse, if cash flow does not back a company's earnings, ultimately those earnings themselves may become suspect, necessitating write-downs of the resulting non-cash assets. Net losses will likely accompany those write-downs.

When free cash margin is positive, a firm is covering all ongoing claims and is able to pay dividends, reduce debt or simply add to its cash coffers. When free cash margin turns negative, ongoing claims are not being met. Cash and short-term investments can be used to meet the shortfall. However, on-hand cash and short-term investments are not an unlimited source of funds. Firms can borrow money to meet their needs. However, even if this were an option, increasing debt levels add new, unwanted risks. Equity issues provide another avenue, but capital markets can be painfully dilutive when share prices are depressed for firms that are seemingly unable to generate cash.

During periods of growth, firms may have problems generating cash as profits are consumed with growth-related investments in working capital and property, plant and equipment needed to support that growth. During recessions, cash generation can be particularly problematic as revenues and profits decline, draining the economic engine that supports cash generation. Regardless of the economic environment, however, free cash margin serves as an important measure of long-term financial health for individual companies, industries and the economy as a whole. The Lab thinks that by periodically examining their cash generating ability, investors will gain insight into the overall financial health of important segments of U.S. firms. With all "non-financial firm industry" data dating back to 2000, it is possible to see how the cash-generating performance of these firms presently compares with their performance during previous periods of economic contraction (e.g., 2001 and 2008-2009) and economic expansion.

Cash Flow Definitions

Free cash flow is the cash flow equivalent of the income statement "bottom line". Like net income, free cash flow is available for shareholders after all prior claims have been satisfied. However, also like net income, which, to facilitate analysis, can be divided into certain sub-measures of performance, like gross profit and operating profit, free cash flow can be similarly divided. Thus, while the primary focus of the report is on free cash flow and free cash margin, or free cash flow as a percentage of revenue, it analyzes the fundamental drivers underlying two distinct, but also closely related, measures of cash flow:

1) Operating cash flow and operating cash margin - cash flow from operations after interest charges and income taxes. Operating cash margin is operating cash flow divided by revenue.

2) Free cash flow and free cash margin - cash flow available for common shareholders that can be used for such discretionary purposes as stock buybacks and dividends without affecting the firm's ability to grow and generate more. This measure is calculated as operating cash flow less preferred dividends and net capital expenditures. Free cash margin is free cash flow divided by revenue.

Data and Methodology

Data for our study are provided by Cash Flow Analytics, LLC[1]. As noted, each data amount is for a rolling twelve-month period ending with the quarter end in question. For example, cash flow amounts for June 30, 2011 represent amounts for the twelve months (four quarters) ending June 30, 2011.

The 44 analyzed industries are as follows:

CICS	Industry	CICS	Industry
1	Agricultural	23	Automobiles and trucks
2	Food Products	24	Aircraft
3	Candy and Soda	25	Shipbuilding and railroad equipment
4	Beer and Liquor	26	Defense
5	Tobacco Products	27	Precious metals
6	Recreation	28	Non-metallic and industrial metal mining
7	Entertainment	29	Coal
8	Printing and Publishing	30	Petroleum and natural gas
9	Consumer Goods	31	Utilities
10	Apparel	32	Communications
11	Healthcare	33	Personal services
12	Medical Equipment	34	Business services
13	Pharmaceutical Products	35	Computer hardware
14	Chemicals	36	Computer software
15	Rubber and Plastic Products	37	Electronic equipment
16	Textiles	38	Measuring and control equipment
17	Construction Materials	39	Business supplies
18	Construction	40	Shipping containers
19	Steel Works, etc	41	Transportation
20	Fabricated Products	42	Wholesale
21	Machinery	43	Retail
22	Electrical Equipment	44	Restaurants hotels motels

[1] Cash Flow Analytics, LLC, 1727 Malvern Place, Duluth, Georgia, 30097. www.cashflowanalytics.com. Charles Mulford is a principal in Cash Flow Analytics, LLC.

Summary of Results for all non-financial companies

Median free cash margin declined for the fifth straight quarter off of its March 2010 high of 7.18%. The indicator was reported at 4.63% for the twelve months ended June 2011, below the 5.20% reported in March 2011, continuing a recent post-recession decline. The measure is now approaching the 4.00% to 4.50% levels seen before the recession began.

Drivers of Free Cash Margin

ALL INDUSTRIES (Median Measures)	Q2 2010 (June 2010)	Q1 2011 (March 2011)	Q2 2011 (June 2011)	Effect on FCM (Q2 2011 vs. Q1 2011)
Revenue (millions)		**551.41**	**633.57**	
Free Cash Margin	**6.71%**	**5.20%**	**4.63%**	
Operating Cushion %	16.46%	15.59%	15.78%	Driving UP
Gross Margin % (before depreciations)	42.41%	43.47%	43.15%	Driving DOWN
SGA% (before depreciation)	19.15%	20.94%	20.58%	Driving UP
Cash Cycle (rev days)	49.66	50.76	51.17	Driving DOWN
Accounts Receivable (rev days)	52.26	52.80	53.12	Driving DOWN
Inventory (rev days)	22.63	23.14	24.00	Driving DOWN
Accounts Payable (rev days)	25.23	25.18	25.95	Driving UP
Income tax to Rev %	0.90%	1.06%	1.09%	Driving DOWN
Cap Exp. to Rev %	2.65%	3.01%	3.16%	Driving DOWN

Although operating cushion increased, investments in inventory and capital expenditures drove free cash margin lower, continuing a trend that began with the end of the recession in late 2009. The June 2011 reporting period did see increases in median revenues and free cash flow.

Operating cushion rose to 15.78% for the twelve months ending June 2011 from 15.59% for the period ending March 2011, reflecting the net effect of a decline in gross margin (before depreciation) to 43.15% from 43.47% and a decline in SG&A% (before depreciation) to 20.58% from 20.94%.

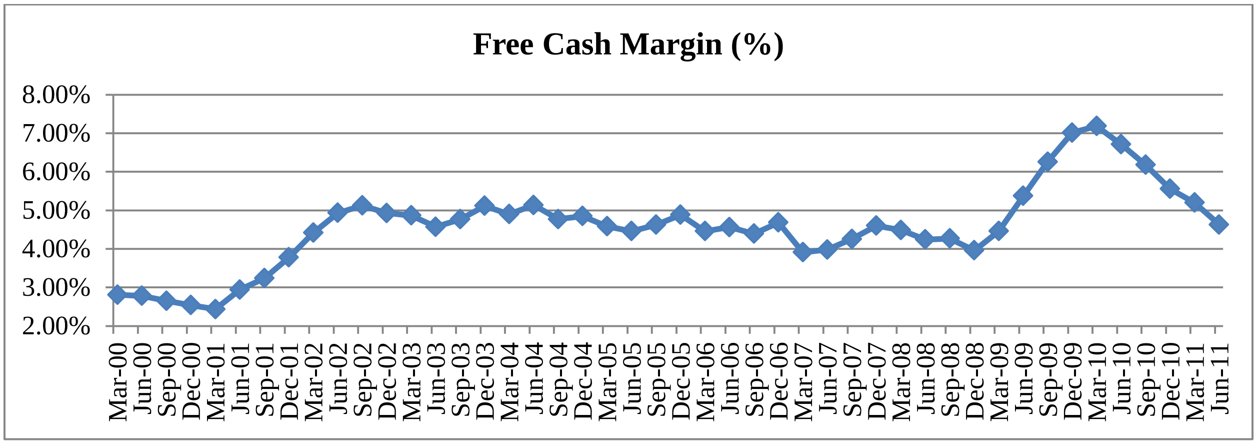
During the June 2011 reporting period, companies continued increasing investments to support growth. In particular, inventory days increased to 24.00 from 23.14 in March and accounts receivable days grew to 53.12 days from 52.80 in March. Capital expenditures were also increased, rising to 3.16% of revenue in June 2011 from 3.01% in March.

In the twelve months ended June 2011, median revenues began to show a noteworthy improvement, increasing 14.90% to $633.57 million from $551.41 million in March 2011. Free cash flow also turned up in the June reporting period, increasing 4.23% to $21.60 million from $20.72 million in March.

Increases in inventory and capital expenditures notwithstanding, sample companies continued to report significant balances of cash and short-term investments. Measured at over 15% of revenue, (15.01% for June 2011), these liquid assets are holding at levels that are 50% higher those observed before the recession began.

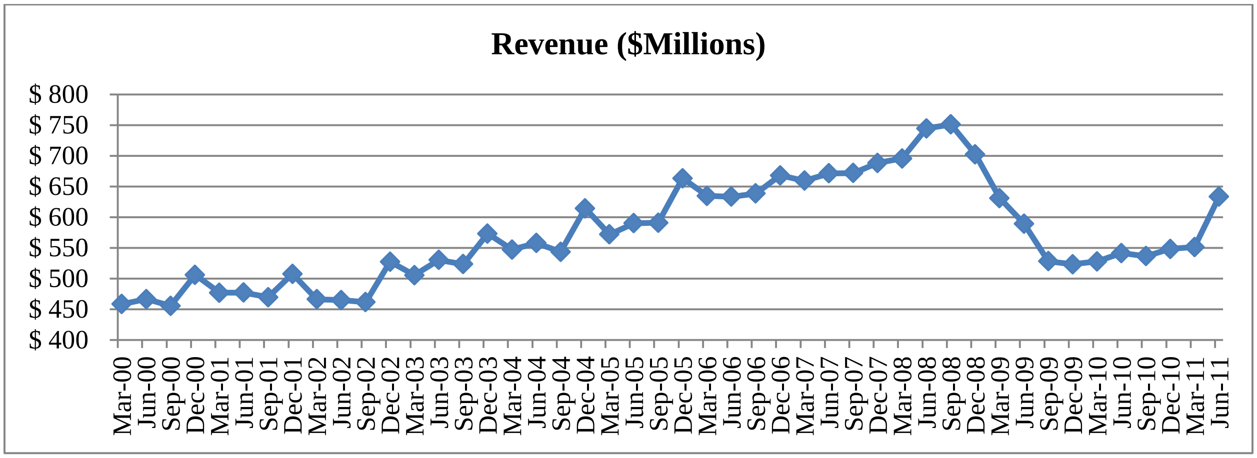
In the exhibits below we present a graph of free cash margin and several of its underlying drivers. These exhibits were constructed with data from the complete sample of non-financial companies, including all non-financial industries. A total of 3,017 companies are included. For more details on each individual industry, please refer to the individual industry spreadsheets that are available on our website (www.mgt.gatech.edu/finlab).

All Non-financials, 2000 – Q2 2011



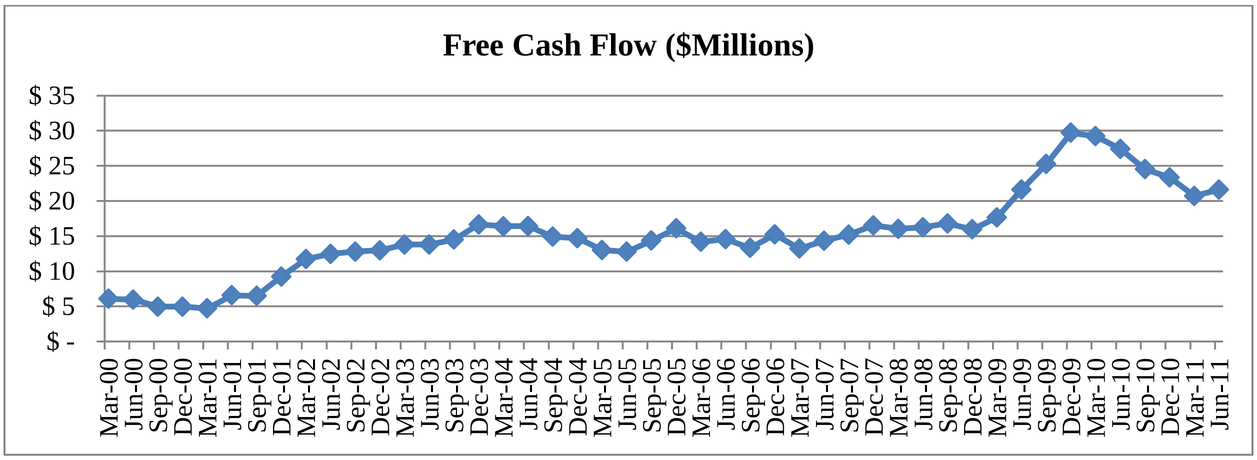
Median free cash margin has now declined for five straight quarters. At 4.63%, it is now approaching the 4.00% to 4.50% level see before the most recent recession began.

All Non-financials, 2000 – Q2 2011



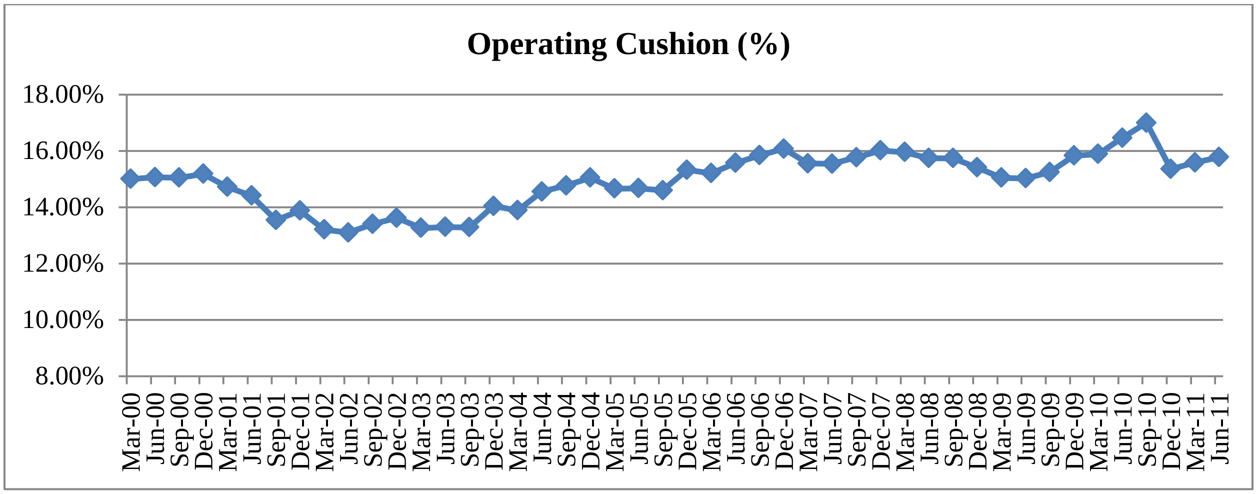
An upward bias in median revenues following the recession-related decline picked up steam during the twelve months ended June 2011. Median revenues increased 14.90% during the period, one of the higher growth rates observed since we began collecting data.

All Non-financials, 2000 – Q2 2011



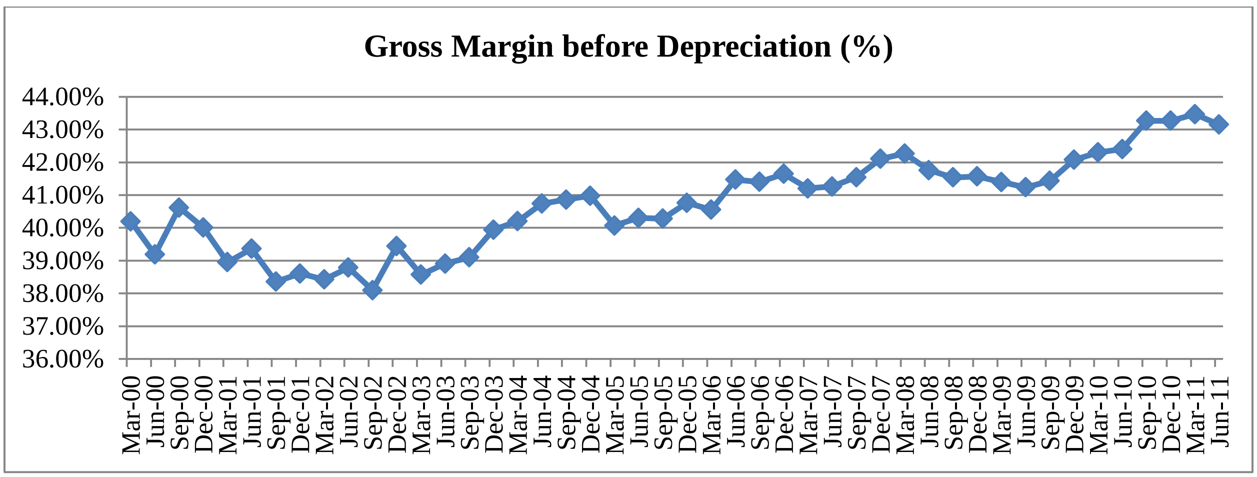
As a result of higher median revenues, a lower free cash margin notwithstanding, median free cash flow increased 4.23% to 22.00 million during the twelve months ended June 2011 from 20.72 million in March.

All Non-financials, 2000 – Q2 2011

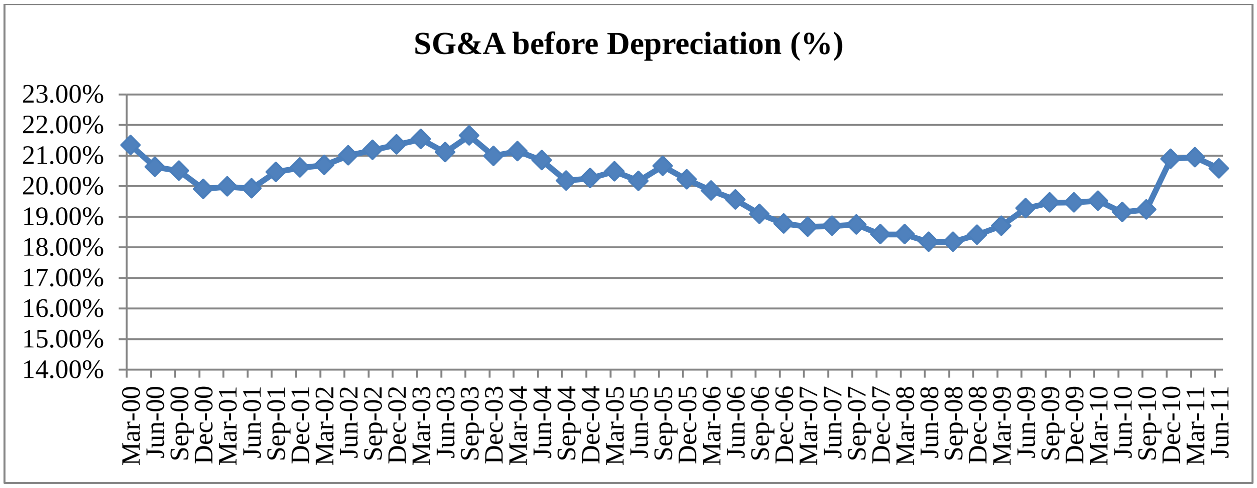


Driven primarily by a decline in SG&A expenses as a percent of revenue, median operating cushion, operating profit before depreciation, pushed higher to 15.78% during the twelve months ended June 2011 from 15.59% in March,

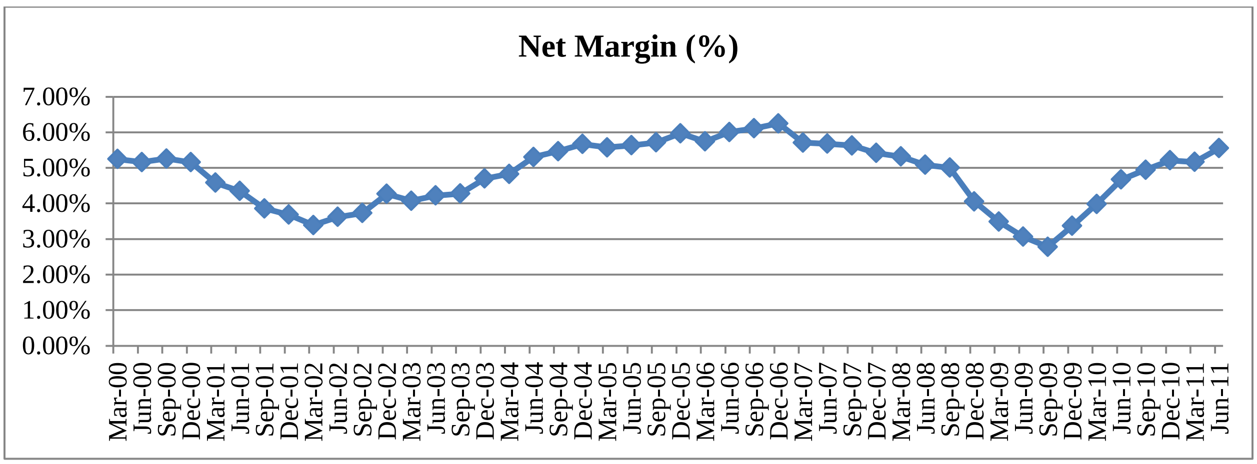
All Non-financials, 2000 – Q2 2011



All Non-financials, 2000 – Q2 2011

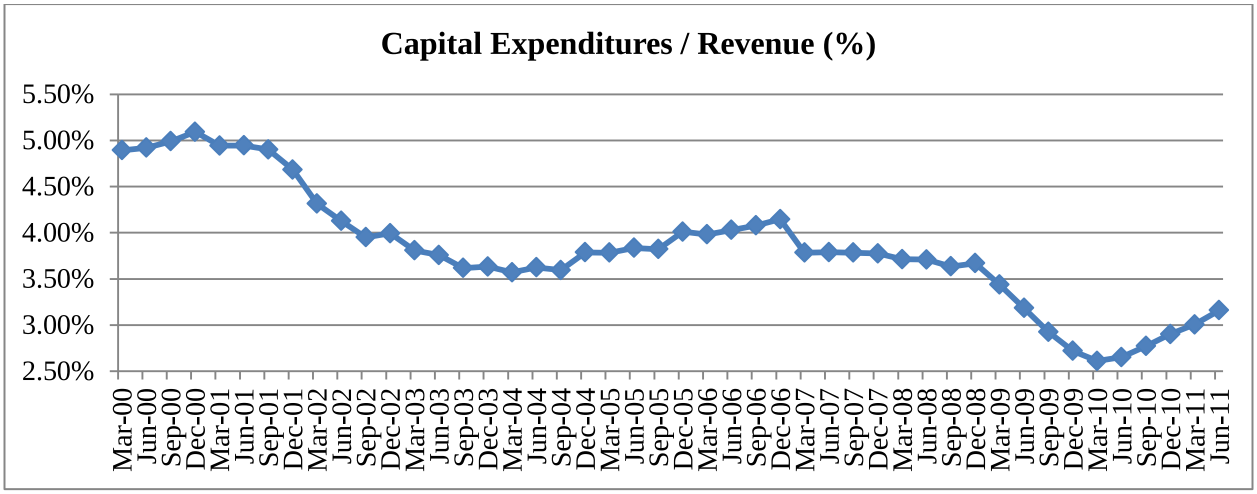


All Non-financials, 2000 – Q2 2011



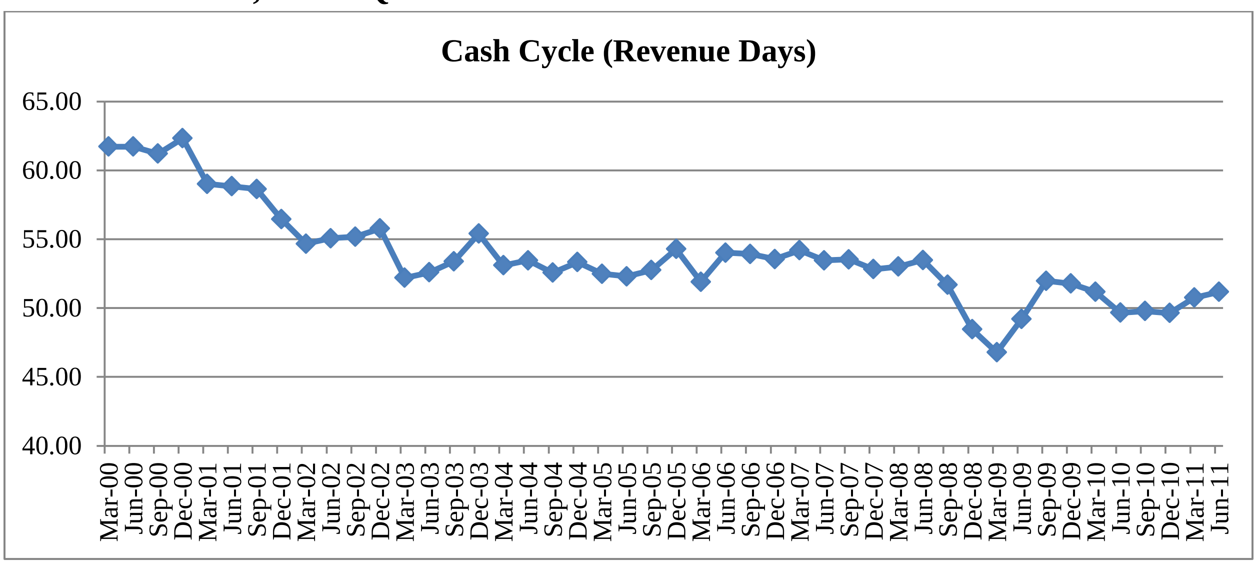
Median net margin has been on an increasing trend since September 2009 when revenues began to flatten.

All Non-financials, 2000 – Q2 2011



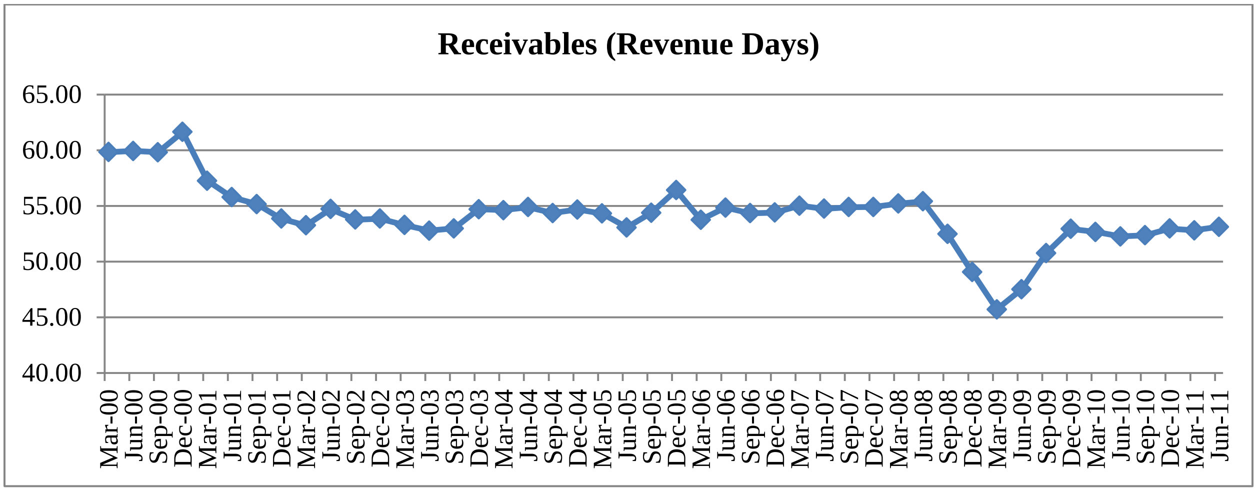
Continuing a recent trend, capital expenditures as a percentage of revenue increased. However, at 3.16%, the metric still remains well below historical norms.

All Non-financials, 2000 – Q2 2011

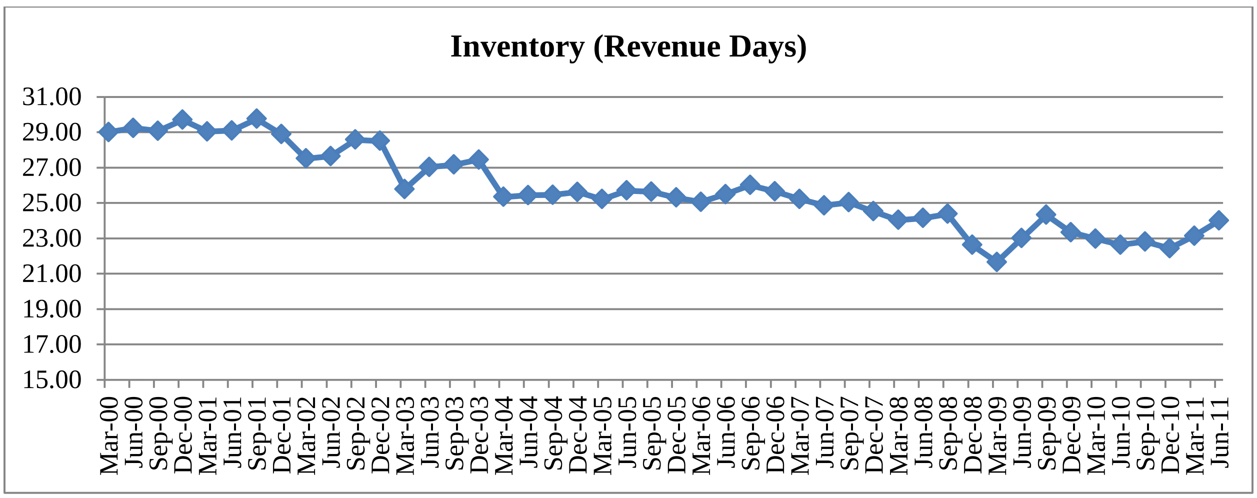


The cash cycle, which measures the proportion of operating cash flow carried in working capital and is measured as receivables days plus inventory days less payables days, increased to 51.17 days in the twelve months ended June 2011, from 50.76 days in March. While accounts payable days increased slightly, accounts receivable days and inventory days also increased, raising the cash cycle.

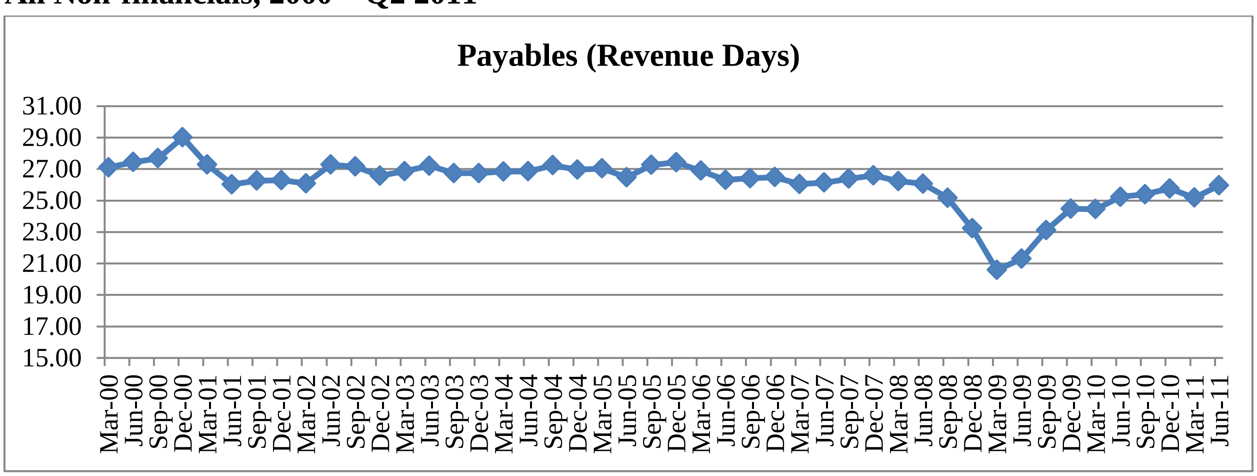
All Non-financials, 2000 – Q2 2011



All Non-financials, 2000 – Q2 2011



All Non-financials, 2000 – Q2 2011



Individual Industry Results

Of the 44 industries studied, during the twelve months ended June 2011 when compared with the twelve months ended June 2010, there is a moderate to substantial improvement in free cash margin in **3** industries, relatively stable free cash margin in **22** industries, and **19** industries with declining free cash margin.

CICS	Industry	Increasing	Stable	Declining
1	Agricultural		x	
2	Food Products		x	
3	Candy and Soda			x
4	Beer and Liquor		x	
5	Tobacco Products		x	
6	Recreation		x	
7	Entertainment		x	
8	Printing and Publishing			x
9	Consumer Goods			x
10	Apparel			x
11	Healthcare		x	
12	Medical Equipment			x
13	Pharmaceutical Products		x	
14	Chemicals			x
15	Rubber and Plastic Products			x
16	Textiles		x	
17	Construction Materials			x
18	Construction		x	
19	Steel Works, etc		x	
20	Fabricated Products			x
21	Machinery			x
22	Electrical Equipment			x
23	Automobiles and trucks		x	
24	Aircraft			x
25	Shipbuilding and railroad equipment	x		
26	Defense	x		
27	Precious metals	x		
28	Non-metallic and industrial metal mining			x
29	Coal		x	
30	Petroleum and natural gas			x
31	Utilities		x	
32	Communications		x	
33	Personal services			x
34	Business services		x	
35	Computer hardware		x	
36	Computer software		x	
37	Electronic equipment		x	
38	Measuring and control equipment			x
39	Business supplies			x
40	Shipping containers		x	
41	Transportation			x
42	Wholesale			x
43	Retail		x	
44	Restaurants hotels motels		x	
	Total	**3**	**22**	**19**

Please refer to the individual industry spreadsheets, available on our website, for charts and further details on each of the 44 industries outlined above.

The Standouts: A Closer Look

The drivers of improvements or declines in free cash margin consist of factors that impact profitability and efficiency. On the profitability front, operating cushion measures operating profit, exclusive of the non-cash expenses, depreciation and amortization. Factors impacting operating cushion consist of gross margin (excluding depreciation and amortization), and SG&A% (excluding depreciation and amortization). Also impacting profitability and a firm's ability to generate free cash flow, but excluded from operating cushion, is income taxes paid, which is measured as a percent of revenue. Capital expenditures do not impact profitability directly, but through depreciation on fixed asset additions. However, these expenditures are subtracted in computing free cash flow. It is also important to look at capital expenditures because these are investments in fixed assets that will likely improve a company's ability to generate revenue, and subsequent profit, in the future. Like operating expenses and taxes, capital expenditures are measured as a percent of revenue.

On the efficiency front, increases in receivables and inventory consume free cash flow. Increases in accounts payable provide free cash flow. The combination of receivables days plus inventory days less payables days is a firm's cash cycle. Reductions in the cash cycle provide free cash flow, while increases in the cash cycle consume free cash flow. All of these factors are evaluated when analyzing changes in free cash margin for the standout firms discussed in this section.

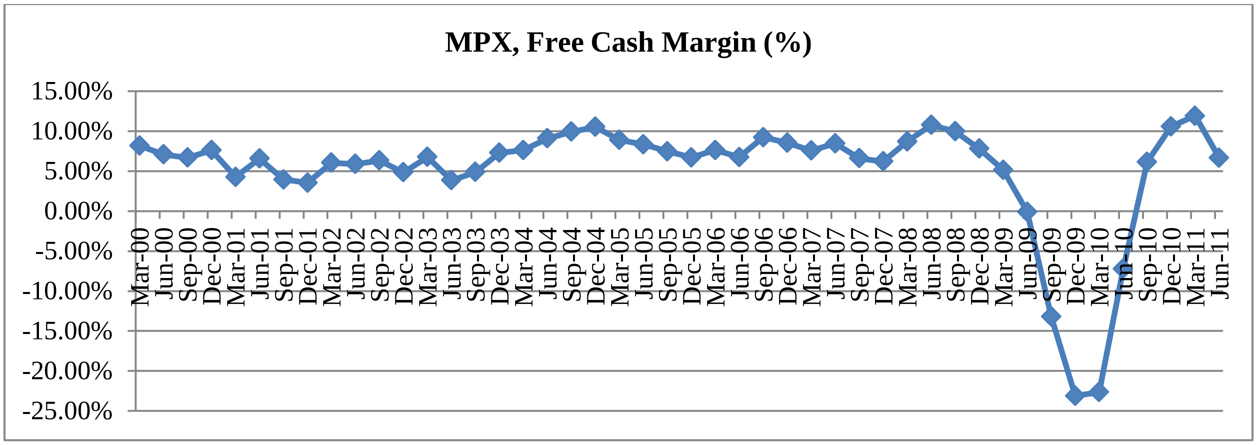
Industries with Improving Free Cash Margin

In the twelve-month period ended June 2011, 3 industries enjoyed improving free cash margin: Shipbuilding and Railroad Equipment, Defense and Precious Metals. We take a closer look at two companies from these three industries: Marine Products Corp. (MPX) in the Shipbuilding and Railroad Equipment industry and Coeur D'Alene Mines Corp. (CDE). in the Precious Metals industry.

Graphs of free cash margin for these two companies are provided below. With each graph we provide a short summary of the primary drivers or factors that are behind the observed changes in free cash margin for the selected firms. For more details regarding the industries, please refer to the separate industry spreadsheets found on our website.

Marine Products Corp (MPX)

Free Cash Margin, Q1 2000 – Q2 2011



Drivers of Free Cash Margin

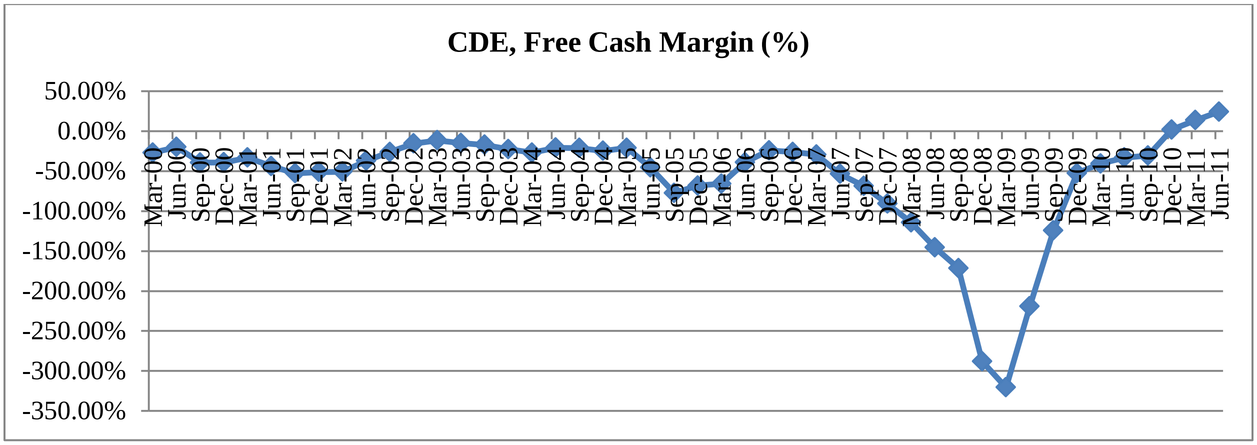
MPX	Q2 2010 (June 2010)	Q1 2011 (March 2011)	Q2 2011 (June 2011)	Effect on FCM (Q2 2010 vs. Q2 2011)
Free Cash Margin	**-7.25%**	**11.90%**	**6.67%**	
Operating Cushion %	-4.18%	7.00%	5.75%	Driving UP
Gross Margin % (before depreciations)	12.47%	19.07%	17.84%	Driving UP
SGA% (before depreciation)	16.65%	12.11%	12.09%	Driving UP
Cash Cycle (rev days)	114.43	70.26	74.42	Driving UP
Accounts Receivable (rev days)	12.03	11.41	10.64	Driving UP
Inventory (rev days)	127.74	75.58	75.95	Driving UP
Accounts Payable (rev days)	25.34	16.73	12.17	Driving DOWN
Income tax to Rev %	-17.26%	1.00%	1.00%	Driving DOWN
Cap Exp. to Rev %	0.14%	0.21%	0.17%	Driving DOWN

Analysis

As evidenced in the graph, the recession wasn't kind to Marine Products Corp., where free cash margin declined significantly in late 2009 and early 2010. During 2010, however, free cash margin snapped back. While down in June 2011 from March 2011, the metric stood at 6.67% for the twelve months ended June 2011, up from -7.25% for the same period ended June 2010. The improvement in free cash margin was driven by an increase in operating cushion, from -4.18% in June 2010 to 5.75% in June 2011 and, due to a drop in inventory days, to a decline in the cash cycle, which improved to 74.42 days in June 2011 from 114.43 days in June 2010.

Coeur D'Alene Mines Corp. (CDE)

Free Cash Margin, Q1 2000 – Q2 2011



Free Cash Margin Drivers

CDE	Q2 2010 (June 2010)	Q1 2011 (March 2011)	Q2 2011 (June 2011)	Effect on FCM (Q2 2010 vs. Q2 2011)
Free Cash Margin	**-33.21%**	**13.70%**	**24.33%**	
Operating Cushion %	32.89%	47.41%	52.44%	Driving UP
Gross Margin % (before depreciations)	41.14%	53.20%	58.60%	Driving UP
SGA% (before depreciation)	5.00%	3.47%	2.74%	Driving UP
Cash Cycle (rev days)	71.03	81.97	79.11	Driving DOWN
Accounts Receivable (rev days)	69.85	40.11	35.99	Driving UP
Inventory (rev days)	69.96	76.57	75.06	Driving DOWN
Accounts Payable (rev days)	68.78	34.71	31.94	Driving DOWN
Income tax to Rev %	-11.00%	-1.84%	-1.84%	Driving DOWN
Cap Exp. to Rev %	50.54%	19.90%	13.88%	Driving UP

Analysis

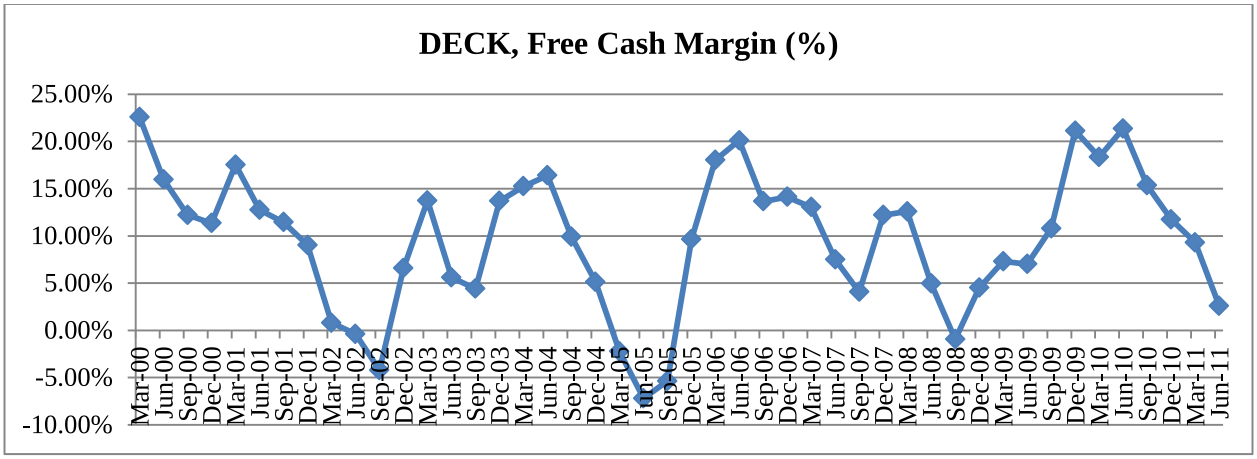
Coeur D'Alene Mines Corp.'s free cash margin jumped from -33.21% for the twelve months ending June 2010 to 24.33% for the twelve months ending June 2011. The primary contributors were an increase in operating cushion, which increased to 52.44% in June 2011 from 32.89% in 2010, and a reduction in capital expenditures, which declined to 13.88% of revenue in 2011 from 50.54% in 2010.

Industries with Declining Free Cash Margin

In the following paragraphs we look more closely at three companies in industries that exhibited a decline in free cash margin: Deckers Outdoor Corp (DECK) and Under Armour Inc (UA) in the appeal industry, and Chesapeake Energy Corp (CHK) in the Petroleum & Natural Gas industry.

Deckers Outdoor Corp (DECK)

Free Cash Margin, Q1 2000 – Q2 2011



Free Cash Margin Drivers

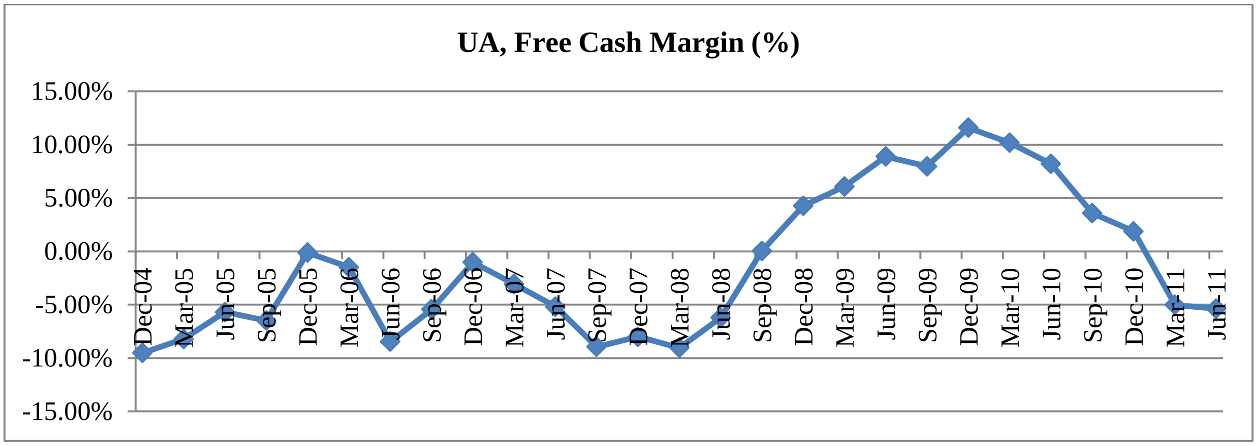
DECK	Q2 2010 (June 2010)	Q1 2011 (March 2011)	Q2 2011 (June 2011)	Effect on FCM (Q2 2010 vs. Q2 2011)
Free Cash Margin	**21.36%**	**9.29%**	**2.60%**	
Operating Cushion %	26.13%	26.23%	23.91%	Driving DOWN
Gross Margin % (before depreciations)	48.51%	51.60%	51.57%	Driving UP
SGA% (before depreciation)	22.39%	25.37%	27.66%	Driving DOWN
Cash Cycle (rev days)	51.28	49.49	77.27	Driving DOWN
Accounts Receivable (rev days)	34.28	27.20	42.15	Driving DOWN
Inventory (rev days)	50.57	37.24	71.85	Driving DOWN
Accounts Payable (rev days)	33.57	14.95	36.73	Driving UP
Income tax to Rev %	8.18%	8.24%	8.24%	Driving DOWN
Cap Exp. to Rev %	1.60%	2.32%	2.78%	Driving DOWN

Analysis

At Deckers Outdoor Corp free cash margin declined to 2.60% for the twelve months ended June 2011 from 21.36% for the twelve months ended June 2010. Primary contributors to the decline were operating cushion, which dropped from 26.13% in 2010 to 23.91% in 2011, the cash cycle, which increased from 51.28 days in 2010 to 77.27 days in 2011, and capital expenditures , which rose from 1.60% of revenue in 2010 to 2.78% in 2011.

Under Armour Inc (UA)

Free Cash Margin, 2000 – Q2 2011



Free Cash Margin Drivers

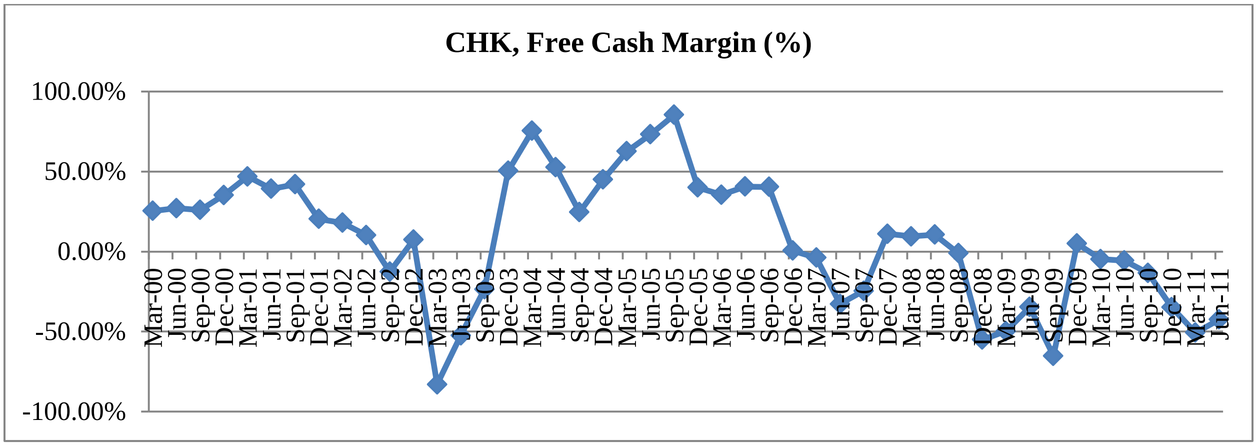
UA	Q2 2010 (June 2010)	Q1 2011 (March 2011)	Q2 2011 (June 2011)	Effect on FCM (Q2 2010 vs. Q2 2011)
Free Cash Margin	**8.20%**	**-5.00%**	**-5.38%**	
Operating Cushion %	15.00%	14.68%	14.12%	Driving DOWN
Gross Margin % (before depreciations)	52.36%	52.32%	51.51%	Driving DOWN
SGA% (before depreciation)	37.41%	37.64%	37.39%	Driving DOWN
Cash Cycle (rev days)	76.59	102.87	98.35	Driving DOWN
Accounts Receivable (rev days)	37.97	51.98	41.30	Driving DOWN
Inventory (rev days)	70.62	79.10	92.03	Driving DOWN
Accounts Payable (rev days)	32.00	28.21	34.98	Driving UP
Income tax to Rev %	4.77%	3.64%	3.64%	Driving UP
Cap Exp. to Rev %	2.54%	3.00%	3.66%	Driving DOWN

Analysis

Under Armour Inc's free cash margin declined to -5.38% for the twelve months ending June 2011 from 8.20% for the twelve months ending June 2010. The main driver of this decline was an increase in the cash cycle to 98.35 days in 2011 from 76.59 days in 2010 and an increase in capital expenditures to 3.66% of revenue in 2011 from 2.54% in 2010.

Chesapeake Energy Corp (CHK)

Free Cash Margin, 2000 – Q2 2011



Free Cash Margin Drivers

CHK	Q2 2010 (June 2010)	Q1 2011 (March 2011)	Q2 2011 (June 2011)	Effect on FCM (Q2 2010 vs. Q2 2011)
Free Cash Margin	**-5.61%**	**-50.70%**	**-42.49%**	
Operating Cushion %	51.14%	37.00%	38.08%	Driving DOWN
Gross Margin % (before depreciations)	79.57%	85.82%	80.50%	Driving UP
SGA% (before depreciation)	28.43%	48.84%	42.42%	Driving DOWN
Cash Cycle (rev days)	(8.46)	4.02	4.16	Driving DOWN
Accounts Receivable (rev days)	56.09	103.39	104.20	Driving DOWN
Inventory (rev days)	-		-	-
Accounts Payable (rev days)	64.55	99.37	100.04	Driving UP
Income tax to Rev %	0.09%	-3.11%	-3.11%	Driving UP
Cap Exp. to Rev %	65.53%	106.00%	85.70%	Driving DOWN

Analysis

Although Chesapeake Energy Corp's free cash margin improved slightly in the second quarter, the metric exhibited a noteworthy decline, to -42.49% for the twelve months ended June 2011 from -5.61% for the twelve months ended June 2010. The main drivers were a reduction in operating cushion from 51.14% in 2010 to 38.08% in 2011 and an increase in capital expenditures to 85.70% of revenue in 2011 from 65.53% in 2010.

Conclusions

Median free cash margin declined for the fifth straight twelve-month reporting period off of its March 2010 high of 7.18%. The indicator was reported at 4.63% for twelve months ended June 2011, below the 5.20% reported for the March 2011 period and continuing a trend that began with the end of the last recession in late 2009. Although there was an increase in operating cushion, investments in working capital, especially inventory, and increasing capital spending drove free cash margin lower. Operating cushion rose to 15.78% for the twelve months ending June 2011 from 15.59% for the period ending March 2011. However, during the June 2011 reporting period, companies continued increasing investments to support growth. In particular, inventory days increased by 0.86 days, from 23.14 days in March 2011 to 24.00 days in June 2011, and capital expenditures rose to 3.16% of revenue in June from 3.01% in March.

In previous reports we noted that reductions in free cash margin could be expected as firms returned to more normal levels of spending on inventory and capital assets. The observed decline in free cash margin was driven by these developments, a healthy sign, especially when observed in the presence of improving operating cushion as seen during the June 2011 reporting period. In effect, we can say that free cash margin is declining for all of the right reasons.

Adding to what is, by most accounts, an optimistic report, during the most recent reporting period we also began to see an increase in median revenues, which increased 14.9% in June 2011 from the March reporting period, and median free cash flow, which increased 4.23% in June from March. Further, with cash and short-term investments remaining at levels that are still about 50% higher than levels seen prior to the last recession, firms hold plenty of ammunition for continued investments in operations, if desired.

Recent declines in free cash margin notwithstanding, at 4.63%, the metric is still higher than levels observed before the last recession. A median free cash margin of 4.00% to 4.50% is more typical for the median non-financial company. At 3.16% of revenue, capital spending remains low when compared with historical levels of 3.50% to 4.00% of revenue. Our expectation is that as the economy gains a stronger footing, capital spending as a percent of revenue should continue to rise, possibly as much as another 50 basis points, pushing free cash margin lower by a similar amount.

There is much concern today about the risk of a double-dip recession. The second quarter results reported here suggest that such concerns may be overblown. If companies were overly concerned about a decline in GDP, we would likely see declines in inventory levels and capital expenditures, instead of the increasing levels observed in the data. Moreover, the spurt in median revenues observed during the second quarter suggests that companies are growing and not declining. Hopefully these trends will continue. Then again, maybe it is still early. The big uncertainty is whether credit problems in Europe might lead to a new world slowdown and a return to recessionary conditions here. If such conditions were to develop, early indicators in our data will be a decline in median revenues, reductions in inventory days and capital expenditures, and, very possibly, an improvement again in free cash margin. We will continue to collect our data and report.